

Transforming the flow of funds in the Japanese financial markets

**Luncheon speech by Jun Mizuguchi¹,
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Introduction

Thank you very much for your kind introduction. Distinguished guests, ladies and gentlemen, good afternoon. It is my great pleasure to be here and speak at this commemorative 30th IIFA Conference in Osaka.

The asset management sector is, needless to say, an important financial business with high potential for growth in the financial industries worldwide. To further develop the asset management sector, it is indispensable to gather sophisticated professionals with expertise from around the world. This will make it possible to accumulate high-quality market information and resources and revitalize the Japanese financial market. Recently, senior representatives from global asset management companies have frequently been visiting the JFSA, emphasizing their business directions and strategies. We understand that many of them are very much interested in entering or actively operating in the Japanese markets and they intend to use more resources for business in Japan. We very much welcome these trends.

We believe that the visits of top-ranking global asset managers to Japan and the resulting increase of business here will further stimulate the existing asset managers' activities in Japan, contributing to the reinvigoration of the financial industry and market as a whole.

With your wisdom and cooperation, we would like to further strive to make the Japanese market more sophisticated and attractive, appealing to the global asset managers and financial intermediaries.

Today, I would first like to explain the overall policy directions of Abenomics in the financial sector, and then focus on the initiatives that JFSA is trying to take, as well as the associated challenges.

¹ This speech represents the speaker's own views, and not necessarily those of FSA Japan.

Abenomics' policy directions in the financial sector

Japan has been posting a current account surplus for 35 years. Our financial assets in the household sector amount to about 16 trillion dollars.

With the Japanese population aging and decreasing in number, it is critical to accumulate the wealth of the Japanese households in a stable manner over the long term.

In Japan, households' financial assets have been held mainly in risk-free assets, such as in cash and bank deposits, which is about 52% of the total household financial assets, and only a small part of their assets are directly invested in equities and investment trust products.

To date, the banking sector has dominated financial intermediation in Japan, and market-based finance is still underdeveloped. Consequently, risk-money has, so far, not sufficiently been supplied to economic activities that will truly need capital for growth. Therefore, we did not have a good balance of fund flow for years in light of the macro-economic point of view.

The Abe administration, which was inaugurated about four years ago, gave top priority to overcoming prolonged deflation and revitalizing the Japanese economy by implementing a number of bold policy measures aimed at sustainable economic growth. Bringing out potential growth capacities of various economic sectors, ordinary profits for the fiscal year 2015 reached a record level in the corporate sector, with improvements in employment and income. We believe that Abenomics has been generating a positive economic cycle.

Under these circumstances, JFSA has been taking a number of measures aimed at facilitating fund flows to sustain the growth among corporates, asset managers, broker-dealers, institutional investors and households who are all in the investment chain. This is because changing the fund flow, which will help to overcome deflation and improve investment benefits will contribute to the growth of the Japanese market and further development of the asset management industry.

I would like to provide brief overviews of each of the main elements of our efforts. There are mainly four aspects.

Corporate governance reform

First, on corporate governance reforms. JFSA has been carrying out the corporate governance reforms, which is a top agenda on the list of reform in the Abe administration.

It will be absolutely necessary to enhance the corporate value of invested companies in the medium- to long-term. This will make possible the sustainable growth of the Japanese economy, urging the households to increase their financial assets in the long run. At the same time, it is also important for long-term investors to make constructive engagement with the invested companies to enhance the corporate values of those companies. From these perspectives, we introduced the Stewardship Code in 2014 and the Corporate Governance Code last year.

Significant initial outcomes have been attained. For example, approximately 80% of the listed companies comply with over 90% of the 73 principles in the Corporate Governance Code as of end-March 2016. About 80% of the listed companies on the first section of the Tokyo Stock Exchange now have two or more independent directors, which represents a significant increase from around 50% last year.

More than 200 institutional investors in total, domestic or foreign, have so far accepted the Stewardship Code.

Furthermore, JFSA established the follow-up council for these two Codes last August to monitor how they were actually implemented by the listed companies and institutional investors to see if there would be any need to make substantive enhancement in the corporate governance practices on the ground. The council made public an opinion statement this February, emphasizing two main issues: that is, ‘the selection of the CEOs’ and ‘the composition, management and review of the Board of Directors’.

For nearly 20 years, stock rallies in Japan have in most cases been led by foreign investors. We were sometimes asked by foreign investors how long it would take until Japanese retail investors start to invest in the Japanese stocks. But, now, Japanese institutional and retail investors are starting to increase the Japanese equity positions gradually in their portfolios. Such investors are generally aiming at a long-term investment horizon. We hope that their investments will become successful on a medium-to-long term basis, benefitting from further corporate governance reforms.

The upcoming challenges for asset managers

Second, turning to asset managers, much expectation is placed on them to play a much greater role for institutional investors, including pension funds. Asset managers, entrusted by pension funds and other long-term funds, are expected to maximize their returns from the investment over the medium-to-long term in fulfilling investor's fiduciary duties to customers. In cases where asset managers invest pension assets into equities, they should engage in effective stewardship activities with invested companies and assess them, judging not from their short-term performance, but from a longer-term perspective.

In the meanwhile, pension funds and other asset owners are able to enhance constructive engagement with asset managers with respect to invested companies by properly assessing those activities of asset managers. Even in the case of index funds or other passive investments, the role of engagement by asset owners is still important, pursuing the improvement of long-term performance. For example, GPIF, Government Pension Investment Fund of Japan, has started to have meetings with its asset managers and to send out questionnaires to invested companies to see how the asset managers are engaging with them. We hope that these kinds of activities toward further engagement would be expanded.

In addition, it would also be important for asset managers to establish such governance framework as ensuring voting and other proper actions for the benefit of asset owners and beneficiaries.

In light of these, JFSA is currently considering to revise the current Stewardship Codes as needed. We expect that the corporate governance reform should be further deepened by focusing more on substance, instead of the mere form of the governance itself, so that institutional investors could truly act for the beneficiaries and engage in proactive dialogue with invested companies from a medium- to longer-term perspective.

At present, it seems that there are not so many institutional investors in Japan who assess the corporate value of companies and invest in them on a longer-term horizon. Globally it is the case that the capital markets are increasingly influenced by passive investment activities including index management and high-frequency algorithmic trading. However, enhancing the efficiency of forming proper pricing in markets would not be possible without institutional investors who evaluate the corporate values of companies and engage in constructive dialogue with invested companies to enhance their corporate values. Proper evaluation of the stewardship activities of asset managers by asset owners would also contribute to changing the way in which asset managers behave. Promoting these dialogues would help to enhance the corporate values of the Japanese companies and in turn result in increasing the asset values of the Japanese investors.

Reform in institutional investors

Third, with respect to institutional investors, there has been progress underway toward refining their investment strategies.

In Japan, there are a number of institutional investors who manage a tremendous amount of assets, such as GPIF, Japan Post Bank and Japan Post Insurance. In the past, most of their portfolios were comprised of JGBs, with the return being low.

However, GPIF has been working on refining its investment strategies and capabilities during the last three years. GPIF has decided to change its benchmark in order to have more diversified portfolios by also investing in domestic equities and overseas assets. Also, it has been improving its asset management capability, together with adequate risk controls. Similarly, Japan Post Bank is making efforts to have more diversified portfolios, through forming a skilled investment team under its new CIO (Chief Investment Officer) recruited from outside the Bank. Japan Post Insurance has also been enhancing its asset allocation strategies and capabilities to have a more diversified global portfolio.

As a whole, however, these changes have just been taking place. When institutional investors continue to refine their investment strategies and capabilities, through recruitment and training of professionals, institutional investors require asset managers and custodians to provide such a level of services as fulfilling advanced needs of institutional investors. This will in turn lead to accumulating high-quality asset managers and custodians in Japan and ultimately contributing to the development of the Japanese market as a whole.

Reforms in households/broker-dealers

Fourth, I would now like to turn to the issues of the Japanese households themselves and broker-dealers or distributors where continued support and measures would seem necessary in our efforts.

As I mentioned, only a small part of Japan's financial assets in the household sector has been directly invested in assets such as equities and investment trusts, which therefore posted lower returns. In fact, Japan's financial assets in the household sector have only increased by 50% during the last 20 years. It is critical to think about how we can ensure necessary funds in golden years after retirement and at the same time increase the financial assets of the wage-earning generations, with the aging of the Japanese population progressing.

Actually, until around 1980, the percentage of equity investments and mutual funds in the total household assets in the US had been at a similar level to that of Japan. Policy supports, including tax incentives such as 401K or IRA, the percentage of equity investments and mutual funds in the US recorded a large increase. We believe that further policy supports are expected to achieve a similar outcome, contributing to a stable increase in financial assets of the Japanese households.

For this purpose, we think that the following three initiatives are important.

First, we believe that long-term, regular and diversified investment would be effective to achieve a stable increase in household assets. Even in our deflation period from 1995 to 2015, some estimates show that if we had made the same amount of investment in stocks and bonds of domestic, developed and emerging countries with one-sixth in each, we could have gained an average annual return of around 4%, which is a similar level to the global growth rate during the same period. Asset class diversification on a global basis would enable us to enjoy the benefits of global economic growth. Also, spreading out the investment period and holding assets for the longer term would make it possible to gain a stable investment return.

Two years ago, we introduced NISA, the individual savings account of Japan, which is a tax-exempt investment account program, for the purpose of making household financial assets more diversified and held for a longer term. At the end of June 2016, the total balance of NISA accounts reached around 81 billion US dollars, and the number of accounts advanced to approximately 10 million. The balance of regular investment, however, accounted for less than 10% of all balance of NISA accounts. In addition, nearly half of the existing NISA accounts have not actually been utilized.

Therefore, there is still room for improvement in NISA schemes, and in this regard JFSA has been requesting tax authorities to introduce a new type of NISA scheme in the FY 2017 tax reform for the purpose promoting cumulative, diversified and long-term investment starting from a small amount. The framework of investment trusts will suit such type of investment.

With respect to the “Defined Contribution Pension” scheme, reforms are also underway and a larger group of people, including government workers and housewives, will be able to participate in it from January next year. It is also planned to introduce what is called the “Default Investment Method’ in order to promote financial products other than principal protection-type products. Continued support for policy measures is envisaged to achieve a stable increase in household financial assets.

Second, I would like to refer to the importance of practical investment education. One of the reasons why the shift from savings to investment has not advanced so far would be that the households did not have enough opportunities to obtain practical investment literacy and education. In response to a survey of adults, around 70% of the respondents said that they have never received any investment education, and nearly two-thirds of them are not even inclined to get investment literacy and education. In addition, households don't necessarily understand well the merit of making a long-term, regular and diversified investment. These results, in fact, demonstrate that practical investment literacy was not necessarily enough at this stage.

To enhance the current level of household investment literacy and education, we will consider providing opportunities for practical investment education, in particular targeting beginners for investment, through various methods and channels. We are also going to consider some mechanism that would help households to easily understand relevant information among different investment trust products, so that people could compare and analyze various investment trusts and select high-quality products among them.

Third, it will be very important for broker-dealers and distributors who sell financial products to act in the best interest of their customers. Another reason why households have not increased securities investments would be that successful experiences in making investment were not necessarily shared by households. As this background, broker-dealers had tendencies to put too much emphasis on increasing commission income in the short run and have not necessarily built the customer-oriented business properly. This may have affected households' experience on investment.

With respect to the sales of investment trust products by banks, their amount of sales increased by 2.2 times between 2009 and 2014, while the balance of investment trusts increased by only 1 trillion yen, from 23 trillion to 24 trillion yen during the same 5-year period. From this, we can see that investment trusts were used as the repeated buy-and-sell products to obtain short-term returns, and they were not necessarily utilized as the assets suited to hold over the long run.

We believe that when broker-dealers provide their customers with high-quality products and services suitable for stable asset building, this will not only bring successful experience by investment to their customers, but also will create trust with customers and in turn contribute to stabilizing the business of broker-dealers themselves.

JFSA has been requesting financial intermediaries that develop, sell, or manage investment trusts to bring home to them that they should act in the best interests of their customers. Some good practices have begun to appear. For example, in evaluating salespersons' performance, broker-dealers have started to put more emphasis on enlarging the balance of assets under management or extending the customer base, rather than revenues or commission fees themselves. Some dealers have introduced new positions for sales-personnel with no relocation in order to strengthen relationships with individual customers and provide valuable consulting services over the long term.

However, there are still cases of concern as to whether broker-dealers are conducting customer-oriented business and further improvements would in general be necessary. In this regard, the Financial System Council, policy advisory body of the JFSA, has started full-fledged discussion on so-called 'fiduciary duty' since July this year. Fiduciary duty here means that financial institutions conduct their business for the best interest of customers. It is also understood internationally that emphasis has been placed on all parties in the investment chain acting for the best interests of customers.

There remains some doubt as to whether sales companies which recommend investment trust products produced by their affiliate investment trust companies are actually serving the best interests of the customers. In this regard, it is good to learn that similar concerns are being discussed in the US and Europe as well.

As I already mentioned, the Financial System Council is currently discussing fiduciary duty, targeting all financial institutions in the investment chain. The Council plans to have an opinion as early as by the end of this year, with respect to what kind of principles should be established and in what framework these principles should be set in place and implemented.

Furthermore, another important issue is the asymmetry of information, due to which customers often find it difficult to understand the risks involved in financial products. JFSA plans to address this issue of asymmetry of information by prompting financial institutions to articulate the rate and amount of commission fees paid by customers, as well as the content of services they will cover. We are also promoting voluntary disclosure of customer-oriented initiatives by financial institutions, including further improvements in sales promotion materials to properly highlight risks involved.

JFSA is intending to build a mechanism where the initiatives of financial institutions to improve the transparency and explanation on their products are to be duly assessed by customers and the financial institutions with better offerings and services will eventually be selected by customers. Through enhancing visibility, we would like to cultivate an environment where financial institutions can compete with each other to deliver higher-quality products and services which will be suited for customers.

Conclusion

For wrap-up, as explained today, the core players in the investment chain face their own challenges. Through addressing these issues, one by one, a path would be opened to achieve fund flows which would contribute to sustainable economic growth. Furthermore, global investment of the Japanese assets through diversification is a way for Japan to contribute to the global economic growth, and it would also enable the Japanese people to benefit from such a global growth and increase their assets and income.

We believe that this virtuous cycle would positively work for the Japanese investors, financial institutions, corporates, and the financial market as a whole, constituting an important and sustainable growth strategy for Japan.

Last but not least, taking this opportunity, I would like to thank you once again for your support and contribution to the revitalization of the Japanese economy and I wish you every success for this conference.

Thank you very much.